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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. 865

THE ESMOND MILLS *et al.*,

Petitioners,

v.

GUY T. HELVERING, Commissioner of Internal
Revenue,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE FIRST CIRCUIT
AND BRIEF IN SUPPORT THEREOF.

ANDREW B. TRUDGIAN,
Counsel for Petitioners.



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OTHER AUTHORITY CITED:

Judicial Code, as amended by Act of February 13,
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THE ESMOND MILLS *et al.*,

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GUY T. HELVERING, Commissioner of Internal
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**PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE FIRST CIRCUIT.**

Petitioners respectfully pray that a writ of certiorari issue to review a judgment of the Circuit Court of Appeals for the First Circuit entered in the above cause on January 23, 1943.

Opinions Below.

The opinion of the Tax Court of the United States (R. 57-63) is not reported. The opinion of the United States Circuit Court of Appeals for the First Circuit (R. 73-80) is reported in 132 F. (2d) 753.

Jurisdiction.

The judgment of the United States Circuit Court of Appeals was entered January 23, 1943. The jurisdiction

tion of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

For the calendar year 1937, the respondent disallowed deductions on the return of the petitioner, The Esmond Mills, in the amount of \$33,904.95 for shrinkage in inventory in the name of its wholly owned subsidiary, The Smithfield Company, and in the amount of \$31,636.19 for payments made by it to The Smithfield Company which were in turn paid by The Smithfield Company to cancel outstanding unfavorable purchase contracts, on the ground that they were not losses sustained or ordinary and necessary expenses paid in the conduct of the business of petitioner. The Smithfield Company held its inventories and entered into its purchase contracts for the sole benefit of The Esmond Mills, its parent corporation, there being an arrangement between the two corporations whereby The Smithfield Company transferred inventories carried in its name to The Esmond Mills at cost plus commissions (R. 41). The Smithfield Company was a mere shell, financially speaking, and unable to make any payments to cancel contracts without the aid of The Esmond Mills. The Circuit Court of Appeals has sustained the respondent's determination of the disallowance of these two deductions on the theory that there was no agency and that a taxpayer cannot ignore the separate entity of a corporation owned by it, even though it is a mere shell. The questions presented are:

I—Whether a taxpayer can ignore the separate entity of a subsidiary corporation which is a mere shell and deduct the subsidiary's losses on its own return;

II—Whether a taxpayer, having elected to conduct a portion of its business through a subsidiary corporation having no substance of its own, is estopped from denying its separate entity even where its subsidiary is a mere shell.

III—Whether there was a relationship of agency between The Esmond Mills and The Smithfield Company, so that the inventory losses of the latter are deductible by the former.

IV—Whether a payment made by a parent to a subsidiary which is immediately turned over to a third person for the purpose of cancelling outstanding unfavorable contractual obligations incurred for the parent's benefit and where the subsidiary is financially unable to make such payment is not an ordinary and necessary business expense of the parent corporation.

Statement.

The facts as found by the Tax Court of the United States (R. 58-61) and as contained in the Stipulation of Facts (R. 39-42) are as follows:

The petitioner, The Esmond Mills, hereinafter called Esmond, was a Massachusetts corporation whose principal place of business was located at Esmond, Rhode Island (R. 59). During the calendar year 1937, it was engaged in the manufacture and sale of blankets and other products (R. 59). The Smithfield Corporation, hereinafter called Smithfield, is a Massachusetts corporation whose principal place of business is also located at Esmond, Rhode Island (R. 59) and whose stock was wholly owned by Esmond (R. 59). During the calendar year 1937, Smithfield was en-

gaged solely in the business of buying cotton and wool, title remaining in its name until transferred to Esmond (R. 60), and it did not pay salaries to officers nor wages or salaries to any employees and did not pay rent (R. 51). Esmond bought a large part of the cotton and wool consumed by it through Smithfield (R. 60). On the transfer of title to Esmond, Smithfield was credited with the cost of the cotton and wool transferred, plus "commissions". This was the only class of income realized by Smithfield during 1937 (R. 60) and reported on its tax return (R. 50). Both companies kept their books on an accrual basis (R. 48, 55) and Esmond valued its inventories at the lower of cost or market (R. 48).

During 1937, Smithfield purchased a quantity of cotton and wool and thereafter the market declined, so that as of December 31, 1937, the market price of such cotton and wool then on hand was \$33,904.95 less than cost (R. 60). Thereupon, Smithfield reduced the book value of the inventory in its name on December 31, 1937 by the amount of \$33,904.95, but did not reflect such reduction in its income and excess profits tax return for 1937 (R. 60) since it did not derive income from the purchase and sale of merchandise, but only from commissions earned (R. 51). Esmond, however, paid this amount to Smithfield (R. 60) and deducted it on its return (R. 46).

During 1937, there was a general decline in the market prices of cotton and wool. During that year, Smithfield had outstanding contracts to purchase cotton and wool, which because of the decline in the market prices, were entered into at higher prices than those then prevailing. Smithfield obtained the cancellation of these unfavorable purchase contracts during 1937 by the payment of \$31,636.19 to certain

brokers which was advanced by Esmond to Smithfield without reimbursement (R. 60, 61). On its income and excess profits tax return for 1937, Esmond claimed this as a deduction.

On June 30, 1940, the petitioner, The Esmond Mills, Inc., a Rhode Island corporation, took over all the assets of Esmond and assumed all its liabilities. It admits that it is the transferee of Esmond and liable for the payment of any deficiencies which may be found to be due from Esmond for 1937.

By letter dated December 20, 1940 addressed to Esmond (R. 11) and by letter dated April 30, 1941 addressed to The Esmond Mills, Inc. (R. 27), the respondent disallowed the deductions of \$33,904.95 and \$31,636.19 taken by Esmond. The petitioners thereupon appealed to the Tax Court of the United States (R. 6, 22) which sustained the respondent's disallowance (R. 63, 64). On appeal to the Circuit Court of Appeals, First Circuit, this order was affirmed (R. 79).

Specification of Errors to Be Urged.

The Circuit Court of Appeals erred:

1—In holding that the evidence does not establish a relationship of agency between Esmond and Smithfield.

2—In holding that Smithfield is a separate corporate entity for tax purposes.

3—In failing to hold that Smithfield's limited activities solely in behalf of Esmond did not result in an agency relationship between the two corporations.

4—In failing to hold that Smithfield's separate entity should be ignored because of its lack of substance.

5—In failing to hold that the payment by Esmond to Smithfield of the sum of \$31,636.19 to be used for the purpose of cancelling its unfavorable purchase contracts which ultimately would have devolved on Esmond was not an ordinary and necessary business expense, or a full deductible loss.

6—In affirming the decision of the Tax Court of the United States.

Reasons for Granting the Writ.

The decision of the Circuit Court of Appeals, First Circuit, in the instant case is in direct conflict with the principles enunciated by this Court in the cases of *United States v. Lehigh Valley Railroad Co.*, 220 U. S. 257; *Southern Pacific Railroad Co. v. Lowe*, 247 U. S. 330, and *Gulf Oil Co. v. Lewellyn*, 248 U. S. 71, to the effect that the corporate entity of a subsidiary corporation will be ignored where it is a mere department, branch or instrumentality of its parent. It is also in direct conflict with the decision of the Circuit Court of Appeals, Fourth Circuit, in the case of *U. S. v. Brager Building and Land Corp.*, 124 F. (2d) 349, with the decision of the Circuit Court of Appeals, Third Circuit, in the case of *North Jersey Title Insurance Co. v. Comm.*, 84 F. (2d) 898, and with the decision of the Circuit Court of Appeals, Tenth Circuit, in the case of *Inland Development Co. v. Comm.*, 120 Fed. (2d) 986. The decision of the Circuit Court of Appeals, First Circuit, in the instant case is likewise in conflict with the decision of the Circuit Court

of Appeals, Second Circuit, in the case of *Helvering v. Community Bond & Mortgage Corp.*, 74 F. (2d) 727, and with the decision of the Circuit Court of Appeals, Ninth Circuit, in the case of *Seufert Bros. Co. v. Lucas*, 44 F. (2d) 528, both of which cases enunciate the principle that expenditures made to minimize losses are deductible from net income either as ordinary and necessary expenses or as losses.

On March 8, 1943, this Court granted writs of certiorari to review the decisions of the Circuit Court of Appeals, Fifth Circuit, in the case of *Comm. v. Moline Properties, Inc.*, 131 F. (2d) 388, Docket No. 660, and of the Circuit Court of Appeals, Eighth Circuit, in the case of *Interstate Transit Lines v. Comm.*, 130 F. (2d) 136, Docket No. 552. The issue in both these cases is identical with that of the instant case, whether a taxpayer can deny for tax purposes the separate entity of a subsidiary which is a mere instrumentality with no substance, and this Court having granted a review in those cases, should grant it in the present case. Further, the Circuit Court of Appeals, First Circuit, in its decision which this petition seeks to review, relied on the decision of the *Interstate Transit Lines* case, *supra*, as a binding precedent and, therefore, its *ratio decidendi* is no longer valid in view of this Court's consent to review that case.

Conclusion.

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

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Counsel for Petitioners.